

It Never Hurts to Enlist Some High-Class Help

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Published: March 16, 2007

<http://www.ft.com/cms/s/34780de0-d3dc-11db-8889-000b5df10621.html>

There is no single answer to how great investors find their best investment ideas. Some scour databases and run stock screens for signs of undervalued companies. Others rely on industry contacts to identify actionable trends or early signs that a company is undergoing positive change. All are voracious readers and often identify ideas in this way. And there is no substitute for long experience – as a friend of mine puts it, “living in the world”; drawing from a deep base of knowledge about industries and companies to see patterns and opportunities that others are missing.

Another great source of ideas? “We learn a lot from other investors,” says hedge fund manager Ricky Sandler, who runs the highly successful Eminence Capital. “I’m not afraid of ideas owned by other people but you obviously need to do your own work and make sure the ideas fit what you do.”

Bruce Berkowitz, manager of the market-beating Fairholme Fund, agrees: “Why wouldn’t you look at what other great investors have found?”

Some investors reject this approach and have what I call a “not-invented-here” syndrome, but I think this is short-sighted. If a like-minded investor with a spectacular long-term record is buying something, why wouldn’t I take a hard look? After all, my objective is not to come up with unique, original ideas – I just want to make my investors money.

The approach has paid off handsomely over time, as some of my biggest winners have come from other investors. For example, a friend in the business shared with me the idea for our biggest percentage winner, CKE Restaurants, which owns Carl’s Jr and Hardees. With the stock under \$4 a few years ago, his thesis was that Carl’s Jr, by itself, was worth what the market was valuing the company for, so investors got Hardees for free. He did not think Hardees was worth much, but it was a free option so he made it a small position in his fund.

When I did my analysis of the company, however, my scuttlebutt research on Hardees’ new “Thickburger” menu led me to believe that a big turnround of one of the worst restaurant chains in America was in the offing, so I loaded up. Hardees did, in fact, turn round and the stock has skyrocketed to more than \$19.

Even if you are not plugged into the idea network of professional investors, you can still follow what they do by reading the filings required of mutual funds and hedge funds.

For one of the publications I co-edit, SuperInvestor Insight, we analyse the investment activity of an elite group of about 30 value-oriented hedge fund managers (plus Berkshire Hathaway), based on the Form 13F filings they are required to make at the end of each quarter with the Securities and Exchange Commission.

The idea, again, is not to parrot what these great investors are doing after they have already done it, but to identify potential ideas worthy of a closer look – especially those in which the stock price has fallen from the point at which the super investor was buying it.

At the end of last year's fourth quarter, for example, at least three investors we track established new positions or increased their existing positions in a total of 11 companies (excluding two that have since accepted takeover offers): Qualcomm, Berkshire Hathaway, CVS, Bed Bath & Beyond, Federated Department Stores, Legg Mason, ConocoPhillips, Corning, Fidelity National Financial, Home Depot, Ligand Pharmaceuticals and McDonald's.

The funds I manage already own two of those, Berkshire Hathaway and McDonald's, which are firing on all cylinders, yet have moderately valued stocks.

Those on the list that we have also taken a hard look at include Legg Mason, which continues to work through integration issues from its acquisition of Citigroup's money-management business – a deal for which the market's initial enthusiasm drove Legg's shares to a price 40 per cent above today's level.

We would also be interested at the right entry price in Bed Bath & Beyond and Home Depot. Each largely created its sector of the retail market – Home Depot in do-it-yourself home improvement and Bed Bath & Beyond in room-specific home furnishings – and benefited from years of remarkable uninterrupted growth. But as growth has slowed and, more recently, fears related to the housing downturn took hold, the shares have traded at valuations not seen in a long time.

It is not surprising that some very smart investors have seen an opportunity in each company's shares.

One's record as an investor is ultimately a function of one's own independent judgment and decision-making. But as individualistic as investing is, it never hurts to enlist some high-class help from time to time.

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